No. 13,148

United States
COURT OF APPEALS
for the Ninth Circuit

HUGH H. EARLE, Collector of Internal Revenue for the District of Oregon,

Appellant,

v.

W. J. JONES & SON, INC., a Corporation,

Appellee.

UNITED STATES OF AMERICA,

Appellant,

v.

W. J. JONES & SON, INC., a Corporation,

Appellee.

On Appeals from the United States District Court for the District of Oregon.

BRIEF OF APPELLEE

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BRIEF OF APPELLEE

OPINION BELOW

The District Court rendered no opinion; its Findings of Fact and Conclusions of Law are set forth at R. 52-66.

JURISDICTION

Appellee taxpayer, an Oregon corporation maintaining its principal office in Portland, Oregon, filed with the Collector of Internal Revenue for the District of Oregon claims for refund of 1944 federal excess profits taxes and 1946 and 1947 federal income taxes (Exhibits* 6, 7, 8, R. 172-184). Such refunds result from the carry back of a net operating loss disclosed in the 1948 income tax return filed by taxpayer on or about March 15, 1949, with the Collector of Internal Revenue for the District of Oregon (R. 54). The refund claims were filed on November 4, 1949 (R. 55-56), within the time allowed by I.R.C.† Section 322 as required by I.R.C. Section 3772 (a)(1). No notices of allowance or disallowance of the refund claims were received by taxpayer under I.R.C. Section 3772. Within the period permitted by I.R.C. Section 3772 (a)(2) taxpayer on September 27, 1950, brought two actions on the claims in the United States District Court for the District of Oregon.

One such action (R. 5-14) was brought against Hugh H. Earle, present Collector of Internal Revenue for the District of Oregon, for recovery of the portion of the taxes collected by him. Jurisdiction of the District Court over this action exists by virtue of 28 U.S.C., Section 1340.

The other such action (R. 18-23) was brought against the United States of America for recovery of the portion

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*All the exhibits referred to in this brief are plaintiff's exhibits.

†The reference I.R.C. used in this brief means Internal Revenue Code.

of the taxes collected by a Collector of Internal Revenue who was not in office as such collector when the action was commenced. Jurisdiction of the District Court over this action exists by virtue of 28 U.S.C., Section 1346 (a)(1).

By consent of the parties and approval of the court, the two actions were consolidated and tried together without a jury. On June 12, 1951, a single judgment in favor of taxpayer was entered in both actions by the District Court for the District of Oregon (R. 66-67). Notices of appeal from such judgment were filed by the Collector and the United States on August 8, 1951 (R. 67-69). Jurisdiction of this Court to hear this appeal is conferred by 28 U.S.C., Sections 1291 and 1294.

QUESTION PRESENTED

Whether or not the District Court was clearly erroneous in concluding that 32 promissory notes of a Mexican corporation owned by taxpayer in 1948 were what they purported to be, and constituted debt obligations within the meaning of I.R.C. Section 23 (k).

If such notes were debt obligations, rather than evidence of contributions to capital, appellants do not question that taxpayer should be allowed a bad debt deduction of $134,555.21 for 1948,* and appellants concede (R.

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*In appellants' brief the "Question Presented" is limited to whether the notes represented debts or contributions to capital. If the notes were debt obligations, appellants do not contest that the notes became worthless in 1948 to the extent claimed, or that the notes had an adjusted basis to taxpayer sufficient to justify the deduction in the amount claimed.

46) that such bad debt deduction entitles taxpayer to the claimed net operating loss for 1948 and to the claimed refunds for 1944, 1946 and 1947.

STATUTE

The basis of the controversy is I.R.C. Section 23 (k), the pertinent portion of which reads as follows:

> "SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * * *
>
> (k) Bad Debts.—
>
> (1) *General Rule.* — Debts which become worthless within the taxable year; . . . and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction . . . . "

STATEMENT

While the actions technically involve refunds of excess profits taxes for 1944 and income taxes for 1946 and 1947, the basis of the controversy is a 1948 bad debt deduction in the sum of $134,555.21 claimed by taxpayer as the major portion of a $138,379.48 net operating loss disclosed on its 1948 income tax return. If such 1948 bad debt deduction is allowable, taxpayer is entitled to the 1944, 1946 and 1947 refunds claimed by it.

The District Court held that the bad debt deduction

is allowable. A concise statement of the case is contained in Findings of Fact XII through XXXIV made by the District Court as the basis for its decision in favor of taxpayer. The statements below are substantially direct quotations from these findings of the District Court, and for the purposes of this brief such findings are divided into two categories herein referred to as "Primary Facts" (Findings XII through XXII) and "Supplemental Facts" (Findings XXIII through XXXIV):

Primary Facts (R. 56-59):

During the year 1948 taxpayer was the unqualified holder and owner of 32 promissory notes in the aggregate principal amount of $121,763.74, duly issued by Mina del Refugio, S. A., a corporation duly organized and existing under and by virtue of the laws of Mexico (hereinafter referred to as the "Mexican Corporation").

On or about August 31, 1946, taxpayer received 28 of said 32 notes from Clayton R. Jones for a valuable consideration equal to the aggregate principal amount of $102,930.96, plus $4,654.57 accrued interest thereon to August 31, 1946. The remaining four of the 32 notes were received by taxpayer from Clayton R. Jones on December 31, 1946, for a valuable consideration equal to their aggregate principal amount of $18,832.78, making a total consideration of $126,418.31 paid by taxpayer for the 32 notes. Appellants admitted and the District Court found that the 32 notes were acquired by taxpayer for a valuable consideration.

When the 32 notes were received by taxpayer on August 31, 1946, and December 31, 1946, for the ag-

gregate consideration of $126,418.31, the notes were reasonably worth such consideration paid for same, and taxpayer and the officers of the Mexican corporation fully expected that the notes and interest would be fully paid.

After receipt of the notes from Clayton R. Jones, taxpayer accrued interest on the notes in the sum of $2,300.22 for 1946, $7,305.84 for 1947 and $7,305.84 for 1948 making total accrued interest of $16,911.90. Such accrued interest was reflected in taxpayer's net income for federal income tax purposes for the subject years. The $16,911.90 in accrued interest, plus the aforementioned aggregate consideration of $126,418.31, made a total of $143,330.21 which taxpayer paid or accrued for the 32 notes.

The Board of Directors of the Mexican Corporation duly held a meeting on December 27, 1948, at which the board ratified the termination of all operations of the Mexican Corporation, confirmed the sale of all its equipment and further directed the immediate abandonment of all real property, mining claims and other assets. At such meeting the directors determined that no more than $22,500.00 could be salvaged from all of the corporate assets.

The 32 notes were worthless in 1948 to the extent of $134,555.21, said amount being the difference between $143,330.21 (the consideration paid and accrued by taxpayer for the notes) and $8,775.00 (the maximum amount which taxpayer could expect to recover on the notes); and on December 31, 1948, taxpayer properly

charged the notes off on its books in the sum of $134,-555.21 by (a) debiting "bad debts" in the amount of $143,330.21, (b) crediting "notes receivable" in the amount of $121,763.74, (c) crediting "interest" in the sum of $21,566.47, and (d) setting up on its books $8,775.00 as the estimated amount of recovery on the notes. The amount actually received by taxpayer on the notes subsequent to such charge-off was $8,694.42, which is $80.58 less than the $8,775.00 estimated recovery.

The 32 notes charged off by taxpayer in 1948 were not worthless prior to 1948.

At no time during 1948 nor at any other time did taxpayer own any capital stock or any other equity interest in the Mexican Corporation.

Taxpayer's accounting period is the calendar year and taxpayer keeps its books on the accrual basis.

Supplemental Facts

Clayton R. Jones made loans to the Mexican Corporation exidenced by notes duly issued for a valuable consideration, and 32 of the notes so issued to Clayton R. Jones were the 32 notes assigned by him to taxpayer for value on August 31, 1946, and December 31, 1946.

In addition to the loans to the Mexican Corporation made by Clayton R. Jones, loans were made by John C. Higgins and D. E. Harris, which loans were also evidenced by notes duly issued by the Mexican Corporation for a valuable consideration. Advances in the aggregate sum of $308,378.39 were made by Clayton R. Jones,

John C. Higgins and D. E. Harris, which advances were evidenced by notes duly made, executed and delivered by the Mexican Corporation (including the 32 notes assigned by Clayton R. Jones to taxpayer for value). At the time of making such advances Jones, Higgins and Harris intended that the advances should constitute loans and create a debtor-creditor relationship, and all subsequent actions of Jones, Higgins and Harris in regard to said advances (and the notes evidencing same) have been consistent with such intention that the advances constituted loans and created a debtor-creditor relationship.

Jones, Higgins and Harris acquired the Mexican Corporation for the purpose of exploiting certain gold and silver mining rights having a substantial value obtained by Jones, Higgins and Harris as individuals from two finders named Daniel D. Kroder and Arthur E. Johnson. Pursuant to an agreement dated July 31, 1944 (Exhibit 53, R. 258), Kroder was to receive a one-third stock interest in the Mexican Corporation as a finder's fee for procuring such mining rights for Jones, Higgins and Harris, which interest was later reduced to a 20 per cent stock interest to Kroder and his associate Johnson (10% to each) under a supplemental agreement of August 31, 1944 (Exhibit 54, R. 262). Kroder and Johnson never made any advances or contributions to the Mexican Corporation. The 80 per cent balance of the capital stock of the Mexican Corporation was owned by Jones, Higgins and Harris.

The mining rights acquired by Jones, Higgins and Harris from Kroder and Johnson were transferred by

Jones, Higgins and Harris to the Mexican Corporation through the execution of an option and lease agreement dated October 31, 1944, in the name of the Mexican Corporation (Exhibit 56, R. 269). The mining rights at the time of such transfer to the Mexican Corporation had a very substantial value in excess of the amount payable under said option and lease agreement, and such transfer of the mining rights to the Mexican Corporation by Jones, Higgins and Harris constituted contributions to the capital of the Mexican Corporation.

In the spring of 1945 a third person, Walter M. Wells, and his associates paid $5,000 for the 10 per cent stock interest of Kroder in the Mexican Corporation, and in March, 1946, Jones and Higgins paid $4,000 for the 9 per cent stock interest of Johnson in the Mexican Corporation (Johnson previously having transferred a one per cent interest to an associate of Wells). The asset accounting for such value of the stock was the excess in the value of said mining rights over the amounts payable under the option and lease agreement.

Whether or not the transfer of said mining rights by Jones, Higgins and Harris to the Mexican Corporation constituted contributions to capital, the advances made by Jones, Higgins and Harris to the Mexican Corporation evidenced by the notes duly issued by the Mexican Corporation (including the 32 notes in question) were intended to constitute and did constitute, loans rather than contributions to capital.

The advances to the Mexican Corporation were not made by the stockholders thereof in direct proportion

to their stock ownership because Kroder and Johnson owned 20 per cent of the capital stock but made no advances whatsoever to the corporation.

There were business reasons why Jones, Higgins and Harris intended that their advances to the Mexican Corporation should constitute loans, in that they desired to be repaid such advances before anything was received by or accrued to the finders (Kroder and Johnson), who paid nothing for their 20 per cent stock interest, and they desired to be in as strong a position as possible in the event that the Mexican authorities or general creditors made claims against the corporation.

At the time of the execution of the agreements under which the loans were made to the Mexican Corporation (Exhibits 53, 57, 59, R. 258, 290, 300), Jones, Higgins and Harris expected that the advances required by the corporation would not exceed $50,000, and had no idea that the advances would exceed $300,000. They believed that the loans would be repaid prior to the maturity dates of the notes issued for such loans, and based on their investigations, available engineering reports and blocked-out ore deposits, such belief was reasonable. The liabilities evidenced by the notes of the Mexican Corporation were agreed to be incurred by Jones, Higgins and Harris in the expectancy that the Mexican Corporation would be successful and pay off the obligations.

The loans evidenced by the 32 notes charged off by taxpayer in 1948 were consistently treated as loans and debt obligation on the books of taxpayer and on the books of the Mexican Corporation.

SUMMARY OF ARGUMENT

The conclusion of the District Court that the 32 notes constituted debt obligations should be sustained inasmuch as such conclusion, for the reasons herein mentioned, is far from "clearly erroneous".

The 32 notes of the Mexican Corporation constituted debt obligations in the hands of taxpayer and did not represent contributions to capital because, (i) said notes were in the form of unconditional debt obligations, and (ii) taxpayer did not have or own an interest in the capital stock of the Mexican Corporation. Taxpayer is entitled to recognition for tax purposes as a separate entity distinct from Clayton R. Jones, who assigned the 32 notes to taxpayer for a valuable consideration, and the stock ownership of Clayton R. Jones in the Mexican Corporation, or his activities in regard thereto, are not attributable to taxpayer.

The preceding paragraph is substantially a direct quotation from Conclusion of Law IV of the District Court (R. 64), minus the portion thereof which is not in issue on this appeal. It is taxpayer's contention that the District Court's Findings of Fact XII through XXII (set forth in this brief under the heading "Primary Facts") substantiate such conclusion and are sufficient in themselves to support the bad debt deduction.

If the stock ownership of Clayton R. Jones in the Mexican Corporation, or his activities in regard thereto, are attributable to taxpayer, then Findings of Fact XXIII through XXXIV of the District Court (set forth

in this brief under the heading "Supplemental Facts") support the conclusion that the notes of the Mexican Corporation constituted debt obligations justifying taxpayer's 1948 bad debt deduction.

The preceding paragraph is in essence a direct quotation from Conclusion of Law V of the District Court (R. 65).

ARGUMENT

I. The Conclusion of the District Court Should Be Sustained Unless Clearly Erroneous.

The findings of fact of the District Court are entitled to finality unless clearly erroneous. This proposition is set forth in the argument and authorities contained in the Commissioner's (respondent's) brief in the case of *Schnitzer v. Commissioner,* 183 F. 2d 70 (C.C.A. 9th, 1950) affirming 13 T.C. 43, wherein the Commissioner contended that the findings of the Tax Court should be sustained although based upon a conflict between documentary evidence and oral testimony. The following are pertinent extracts from this brief (pp. 22 and 25-27):

> "Such fact questions [concerning the existence of a debt] are primarily for determination by the trier of the facts, instantly, the Tax Court, and its factual findings here sustaining the Commissioner's determination are entitled to finality 'unless clearly erroneous'. Rule 52(a), Federal Rules of Civil Procedure. *Grace Bros. v. Commissioner,* 173 F. 2d. 170 (C.A. 9th); *Joe Balestrieri & Co. v. Commis-*

sioner, 177 F. 2d 867 (C.A. 9th); *Smyth v. Commissioner,* (C.A. 9th), decided April 5, 1950 (1950 C.C.H., par. 9267).

. . . .

" . . . This testimony as to intent was carefully considered by the Tax Court, which saw the witnesses and observed their demeanor, candor and credibility under examination, and which also carefully found and appraised the many documentary exhibits and other record facts and inferences arising from such facts. On established principles, already adverted to . . . such weighing and analysis of the evidence was properly and primarily within the province of the fact finder. Taxpayers are not entitled, as they appear to think, to come to this Court for what virtually would amount to a trial *de novo* on the record of such a finding as intent. So the Supreme Court recently held, in United States v. Yellow Cab Co., 338 U.S. 338, 340-342, where *inter alia,* it is said (p. 341):

> 'Findings as to the design, motive and *intent* with which men act *depend peculiarly* upon the credit given to witnesses by those who see and hear them.' (Italics supplied.)

"The Tax Court was warranted on the highest authority to afford little weight to such testimony in conflict with contemporaneous documents. *United States v. Gypsum Co.,* 333 U.S. 364, 396, rehearing denied, 333 U.S. 869.

"The Tax Court did not err in declining to accept testimony of interested or friendly witnesses in the nature of general statements, unsupported by contemporary acts and documents, and which in the light of the entire record might reasonably be regarded as inherently improbable. *Greenfield v. Commissioner, supra; Grace Bros. v. Commissioner, supra; Joe Balestrieri & Co. v. Commissioner, supra.* As the Supreme Court has only recently held, in *United States v. National Association of Real Estate Boards,* decided May 8, 1950:

> 'It is not enough that we might give the facts another construction, resolve the ambiguities differently, and find a more sinister cast to actions which the District Court apparently deemed innocent. See *United States v. Yellow Cab Co.,* 338 U.S. 338, 342; *United States v. Gypsum Co.,* 333 U.S. 364, 394-395. We are not given those choices, because our mandate is not to set aside findings of fact "unless clearly erroneous'."

If this Court had no cause to disturb the trial court's decision in the *Schnitzer* case involving a conflict between evidence and testimony, then certainly this Court should not disturb the conclusion of the District Court in the instant case where there is no conflict in evidence or testimony.

It is difficult to understand why the law presented in appellants' brief (Br. 36-39) should differ so greatly from the above statement of the law contained in the brief of the Commissioner in the *Schnitzer* case. Since this Court in a *per curiam* decision affirmed the trial court in the *Schnitzer* case, it would seem that the correct statement of the law is contained in the portion of the Commissioner's brief quoted above, rather than in appellants' brief. Therefore, the conclusion of the District Court should be sustained inasmuch as such conclusion, for the reasons hereinafter discussed, is far from "clearly erroneous," if in fact it is not the only conclusion which can properly be derived from the record.

II. Primary Argument that Record Sustains Conclusion of District Court.

A. The 32 notes of the Mexican Corporation constituted debt obligations in the hands of taxpayer and did not represent contributions to capital because, (i) the notes were in the form of unconditional debt obligations and, (ii) taxpayer did not have or own any interest in the capital stock of the Mexican Corporation.

The 32 notes of the Mexican Corporation were in the ordinary form of promissory notes, payable 2 years after date, together with interest at 6 per cent per annum. Such notes contained no qualifications or restrictions whatsoever. They were duly issued by the Mexican Corporation pursuant to authority conferred by its board of directors at a meeting held on November 20, 1944.

Appellants contend that the 32 notes are not really notes and do not constitute debt obligations within the meaning of I.R.C. Section 23 (k). This contention seems to be based on the fact that the Mexican Corporation issued its notes in proportion to the stockholdings of the promisees, and on the Mexican Corporation's ratio of debt to capital stock.

These factors relied upon by appellants may be pertinent when the taxpayer claiming the bad debt deduction owns stock in the debtor corporation, in addition to the alleged debt obligations, but such factors have no applicability where the taxpayer owns no stock in the debtor. When the holder of alleged debt obligations also owns stock in the debtor corporation, it may be appro-

priate, in certain instances, to regard the purported debt obligations as a mere augmentation of the stock or equity interest, and to treat the total interest of the taxpayer as a stock or equity interest for tax purposes. On the other hand, if the holder of the debt obligations owns no stock in the debtor corporation, there is no stock interest to be augmented, and the debt obligations alone cannot be regarded as constituting a stock interest inasmuch as the holder of the obligations possesses none of the attributes of a stockholder.

The foregoing distinction is borne out by the authorities. In ever bad debt case cited by appellants, the taxpayer owned stock in the debtor corporation in addition to the debt forming the basis for the claimed bad debt deduction. In the instant case, no stock of the Mexican Corporation was owned by taxpayer. The only interest of taxpayer in the Mexican Corporation was that conferred by the 32 notes. Such notes gave taxpayer none of the attributes of a stockholder, so taxpayer's interest in the Mexican Corporation cannot logically be regarded as a stock interest.

In short, where the holder of purported debt obligations also owns stock in the debtor corporation, a question may exist as to whether the stock interest dominates the creditor interest for tax purposes, but no such question is presented where the holder of the obligations owns no stock interest whatsoever in the debtor corporation.

B. Taxpayer is entitled to recognition for tax purposes as a separate entity distinct from Clayton R. Jones who assigned the 32 notes to taxpayer for a valuable consideration, and the stock ownership of Clayton R. Jones in the Mexican Corporation, or his activities in regard thereto, are not attributable to taxpayer.

Appellants' answer to taxpayer's primary argument (under A above) is that the corporate entity of taxpayer should be disregarded, that taxpayer was a mere alter ego of Clayton R. Jones and took the notes with complete notice of all the transactions involved. No authority is cited by appellants for this rather startling contention. For many years taxpayer has been actively engaged in the stevedoring business and has been consistently recognized as a separate taxable entity by the government. While taxpayer should be entitled to recognition as a separate entity even if Clayton R. Jones owned all the stock of taxpayer, any doubt on the subject is dispelled by the fact that Clayton R. Jones owned less than a majority of the stock of taxpayer during 1946, 1947 and 1948 (R. 109).

The fact that taxpayer took the notes with notice of all the transactions seems immaterial. Notice may be important in determining whether the holder of a note is a holder in due course under the negotiable instrument laws, but I.R.C. Section 23 (k) is not limited to holders in due course. Notice has nothing to do with whether an instrument does or does not evidence a debt. Notice of the transactions did not give taxpayer any of the attributes of a stockholder, so such notice could not have converted taxpayer's interest represented by the 32 notes into a stock or equity interest.

The validity of taxpayer's basic argument is substantiated by a decision of the Tax Court, and the Tax Court reputedly takes a strict view as to what constitutes a debt. Practically all of the cases denying bad debt or interest deductions originated in the Tax Court, and in the case of *Wilshire & West. Sandwiches v. Commissioner,* 175 F. 2d 718, this Court found it necessary to reverse the Tax Court because of its overstrict approach to the question. Nevertheless, when faced with a situation similar to that here involved, the Tax Court, in the case of *Washington Institute oi Technology, Inc.,* P-H T.C. Memo. Dec. Par. 51,001 (1951), readily allowed the claimed bad debt deduction.

All of the stock of the taxpayer corporation in the *Washington Institute* case was owned by X, an individual. For the purpose of exploiting an exclusive license agreement X formed a new corporation and transferred the license agreement to it in return for all the capital stock. No working capital was provided the new corporation by X individually, and all of the new corporation's operations were financed by advances from the taxpayer corporation. The Tax Court held (1951 P-H Memo. Dec. p. 7):

> "The record does not substantiate respondent's contention that these advances were contributions to capital and not loans. The debtor and petitioner were separate and distinct corporations, each organized to carry on specific unrelated business. Petitioner received no stock nor evidence of ownership in the debtor corporation in return for the advances . . . "

It is to be noted that the Tax Court was not per-

turbed by the fact that the only contribution to the capital of the debtor corporation made by X was the license agreement to which the Court attributed no value. The fact that the corporation issued stock having an aggregate par value of $100,000 for the agreement does not mean it had such value. The court specifically found that, other than the license agreement, nothing was contributed to the capital of the debtor corporation by X or anyone else. Consequently, the ratio of debt to contributions to capital is not a factor when the creditor claiming the bad debt deduction owns no stock in the debtor.

In the *Washington Institute* case X owned all the stock of both the debtor corporation and the creditor corporation. In the instant case, Clayton R. Jones owned a minority interest in both the Mexican Corporation and taxpayer. If the doctrine of alter ego or notice had any applicability where the creditor owns no stock in the debtor, it would certainly have been applied in the *Washington Institute* case, but the Tax Court recognized the creditor corporation as a separate entity, and held that the record did not substantiate the government's contention that the advances were contributions to capital.

The taxpayer corporation in the *Washington Institute* case made the original advances to the debtor corporation, while taxpayer in the instant case received the 32 notes by assignment. This distinction is immaterial since appellants concede that taxpayer paid value for the notes, and the funds advanced by Clayton R. Jones were received from taxpayer.

III. Supplemental Argument that Record Sustains Conclusion of District Court.

A. If the stock ownership of Clayton R. Jones in the Mexican Corporation, or his activities in regard thereto, are attributable to taxpayer, then the findings of fact of the District Court (set forth in this brief under the heading "Supplemental Facts") support the conclusion that the notes of the Mexican Corporation constituted debt obligations jusifying taxpayer's bad debt deduction.

(1) *The Intent of the Parties Controls.*

The law to be applied is that established by this Court in the *Wilshire* case, supra, wherein this Court stated (175 F. 2d 720 and 721):

> "It is not contended that a corporation is without power to enter into a debtor and creditor relationship with its stockholders. The intent of the parties as to the nature of the transaction controls.
>
> . . . . . .
>
> "The effect of a lending and investing transaction giving creditors, as stockholders, proprietary interest in proportion to their loans, subjects the transaction to close scrutiny, but does not, as a matter of law, require the transaction to be treated as a stock investment, regardless of intent."

While the *Wilshire* case involved the deductibility of interest, the same law applies to the deductibility of bad debts. This is illustrated by the decision of the Circuit Court of Appeals for the Second Circuit in the recent bad debt case of *Matthiessen et al. v. Commissioner,* 52-1 U.S.T.C. Par. 9201 (C.C.A. 2nd, 1952), wherein the Court cites the *Wilshire* case as follows:

"The question as to whether or not advances to a corporation by the principal stockholder or stockholders are actually contributions to capital or loans is not new. It is essentially a question of fact upon which the taxpayer has the burden of establishing his right to such deduction (*White v. U. S.,* 305 U.S. 281 at 294). The status and nature of the transactions when they occurred is the ultimate question to be decided, and the determinative intent (*Wilshire v. Commissioner,* 175 Fed. (2d) 718), is arrived at by the consideration of relevant facts. "Bookkeeping, form, and the parties' expression of intent or character, the expectation of repayment, the relation of advances to stockholdings, and the adequacy of the corporate capital previously invested are among circumstances properly to be considered, for the parties' formal designation of the advances are not conclusive . . . ' "

The District Court applied the correct law and subjected the transaction to close scrutiny, as indicated by the following quotation from Conclusion of Law V (R. 65):

"To determine whether advances in any particular instance should be regarded for tax purposes as constituting debts or contributions to capital it is necessary to consider all of the circumstances, including the intent of the parties at the time the transactions in question were entered into . . . "

Perhaps it was unnecessary for the District Court to have applied the close scrutiny specified in the *Wilshire* case, since that case, and the cases therein cited, involved situations where advances were made by *all* the stockholders in direct proportion to their stockholdings. As stated by the District Court (Finding XXXI, R. 62) the advances to the Mexican Corporation were

not made by the stockholders thereof in direct proportion to their stock ownership because Kroder and Johnson owned 20 per cent of the capital stock and made no advances whatsoever to the corporation.

In any event, the District Court did carefully consider all the circumstances, including the intent of the parties at the time the transactions in question were entered into. The only remaining question under taxpayer's supplemental argument is whether the District Court was clearly erroneous in finding the requisite intent to substantiate the bad debt deduction.

(2) *Evidence of Intent—Written Agreements.*

What better indication or expression of intent can there be than the written agreements under which the advances were made and pursuant to which the notes in question were issued? Such agreements are set forth in Exhibits 53, 57 and 59 (R. 258, 290 and 300, respectively). The basis of the Mexican venture was the mining option agreement (Exhibit 53). Paragraph 4 of this agreement (R. 260) relates that the parties contemplated organization of a Mexican corporation to take over the mining property and that the moneys to be provided by Jones and Higgins "shall be in the form of a loan to said corporation represented by notes of the corporation and repayable within two years from their date . . . ."

Instead of forming a new corporation as anticipated when the above mentioned agreement was entered into, the parties acquired an existing dormant Mexican cor-

poration. Exhibit 57 is an agreement dated November 20, 1944, between the activated Mexican Corporation and Jones, Higgins and Harris. This agreement makes it crystal clear that the advances of Jones, Higgins and Harris were to constitute loans. It is difficult to imagine a more precise expression of intent than that set forth in this agreement (R. 290, and quoted on pages 11 through 14 of appellants' brief). For example, paragraph (d) reads as follows (R. 293):

> "(d) All monies advanced or expended by First Parties for any of the purposes described in Clauses (a) and (b) above, together with the amounts representing the reasonable purchase price and value to the Company of the mining and milling equipment sold and delivered to the Company as stated in Clause (c) above, together with interest thereon in accordance with the terms above stated, shall become obligations of the Company from the dates when such monies were advanced or expended and from the dates of delivery to the Company of the aforesaid equipment, and the Company shall be and remain indebted under open account for the aforementioned amounts and interest thereon as aforesaid to the respective persons who advanced or expended the monies or who sold and delivered the equipment, until such persons shall have been reimbursed by the Company therefor or until the Company shall have executed and delivered to such persons its note or notes therefor as above provided."

At a meeting held on November 20, 1944, the board of directors of the Mexican Corporation adopted resolutions specifically confirming the terms of the above mentioned agreement. The minutes of this meeting (Exhibit 58, R. 295) reiterate that the advances of Jones, Higgins and Harris shall constitute loans. Likewise, the

agreement of March 1945 (Exhibit 59, R. 300) between Jones, Higgins and Harris states that all contributions of the parties, except the amount thereof required to pay up the 5,000 pesos capital stock of the Mexican Corporation, shall be regarded as loans to the corporation, to be represented by notes of the corporation, and that said notes shall be payable either at or before their maturity before any dividends shall be declared by the corporation.

In view of the unequivocal expression of intent contained in these agreements, substantiated by the testimony of Jones and Higgins, the District Court had no alternative but to find the requisite intent. How then can the finding of such intent be so clearly erroneous as to justify reversal of the District Court?

Appellants contend that such clear intent is nullified because the agreements provide that the advances of Jones, Higgins and Harris shall be made in proportion to their stockholdings. Such contention is directly contrary to the law set forth in the *Wilshire* case that advances in proportion to stockholdings do not as a matter of law require the advances to be treated as a stock investment, regardless of intent. The intent controls.

(3) *Business purpose for making loans rather than contributions to capital.*

A strong indication of intent is set forth in Finding XXXII (R. 62) of the District Court that there were business reasons why Jones, Higgins and Harris intended that the advances to the Mexican Corporation should constitute loans, in that they desired to be repaid such

advances before anything was received by or accrued to the finders (Kroder and Johnson), who paid nothing for their 20 per cent stock interest, and they desired to be in as strong a position as possible in the event that the Mexican authorities or general creditors made claims against the corporation. The business purpose set forth in this finding is the reason why the above mentioned agreements (Exhibits 53, 57 and 59) so meticulously provided that the advances should constitute loans rather than contributions to capital.

Appellants seek to nullify the above finding of business purpose by suggesting that the interest of the finders could have been handled through the issuance of preferred stock rather than notes. Counsel for taxpayer knows of no doctrine, and appellants suggest none, which requires that preferred stock must be issued rather than debt obligations where business reasons preclude the issuance of common stock. If business reasons make it infeasible to issue common stock, a corporation should have the option of issuing notes rather than preferred stock, and the notes should be recognized for tax purposes.

In any event, the issuance of preferred stock by the Mexican Corporation would not have accomplished one of the objectives sought by Jones, Higgins and Harris, which was to be in as strong a position as possible in the event that the Mexican authorities or general creditors made claims against the corporation. As set forth in Mr. Higgins' testimony (R. 154-156), Jones and Higgins desired to participate with other creditors, and to have a creditor position in the event the Mexican author-

ities made claims against the corporation. Such business purpose would not have been satisfied by the issuance of preferred stock.

Appellants' brief makes considerable mention of the fact that the Mexican law required new corporations to be 51 per cent owned by Mexican citizens. Appellants have obtained the erroneous impression that a desire to circumvent this Mexican law was the motivating factor behind the issuance of the notes. The testimony of Higgins (R. 154 and 155) discloses that there was an uncertainty whether an increase in the capital stock of an existing Mexican corporation would fall within this law. Such uncertainty in the Mexican law was merely one of the elements taken into consideration. The testimony as a whole makes it perfectly clear that the desire to be in a position to share with general creditors (R. 155, 140-141), to be in as strong as possible position with Mexican authorities (R. 155-156), and the desire to take precedence over the finders (R. 135-137) were the reasons for making loans, rather than contributions to capital. In its findings the District Court does not even mention this uncertainty in the Mexican law as one of the reasons for the issuance of the notes. It seems obvious that the above mentioned agreements (Exhibits 53, 57 and 59) were not drafted for the sole purpose of overcoming an uncertainty in the Mexican law, but were drafted to accomplish the abovementioned objectives.

(4) *Other evidence of intent.*

The findings are replete with other indications of intent, such as Finding XXXIII (R. 63) that Jones, Hig-

gins and Harris expected the advances required by the Mexican Corporation would not exceed $50,000. They believed that the loans would be repaid prior to the maturity dates of the notes issued for such loans, and based on their investigations, available engineering reports and blocked-out ore deposits, such belief was reasonable. The liabilities evidenced by the notes were agreed to be incurred by Jones, Higgins and Harris in the expectancy that the Mexican Corporation would be successful and pay off the obligations. The foregoing findings are amply supported by testimony (R. 97-99, 121-123, 134-135, 144-145).

Another indication of intent is contained in Finding XXXIV (R. 63) of the District Court that the loans were consistently treated as loans and debt obligations on the books of the taxpayer and on the books of the Mexican Corporation. A concrete example of intent is the fact that taxpayer accrued interest on the notes for 1946-1948 which interest was reflected in taxpayer's income for federal income tax purposes (Finding XVIII, R. 58).

(5) *Decisions sustaining debts.*

As previously noted, whether a debt exists for tax purposes is a question of fact to be determined by the trial court upon a consideration of all the facts. Taxpayer believes that there is nothing to be gained by a review of the decisions of other courts involving varying fact situations. Suffice it to point out that in the following comparatively recent bad debt cases (in addition to those mentioned elsewhere in this brief) the trial court

sustained the existence of a debt for tax purposes in spite of stock ownership in proportion to the debt, and in none of these cases were there as strong indications of intent as the agreements pursuant to which the notes of the Mexican Corporation were issued (Exhibits 53, 57 and 59) and the business purpose discussed above: *Lucia Chase Ewing,* P-H T.C. Memo. Dec. Par. 46,235 (1946); *Arthur V. McDermott,* 13 T.C. 468 (1949); *Valentine E. Macy, Jr.,* P-H T.C. Memo. Dec. Par. 49,009 (1949); *Alma de Bretteville Spreckels,* P-H T.C. Memo. Dec. Par. 49,299 (1949); *Ethel S. White,* P-H T.C. Memo. Dec. Par. 47,262 (1947). Also debt obligations were recognized in the following interest deduction cases: *New England Lime Company,* 13 T.C. 799 (1949); *The Toledo Blade Company,* 11 T.C. 1079 (1948); *250 Hudson Street Corporation,* P-H T.C. Memo. Dec. Par. 46,-205 (1946); *The Tribune Publishing Company,* 17 T.C. No. 148 (1952); *H. E. Fletcher Co.,* P-H T.C. Memo. Dec. Par. 51,317 (1951); *Sabine Royalty Corp.,* 17 T.C. No. 130 (1951); Lansing Community Hotel Corporation, 14 T.C. 183 (1950), affirmed, 187 F. 2d 487 (C.C.A. 6th, 1951).

B. Consideration of features which appellants contend militate against recognition of the notes as debt obligations.

(1) *Advances in proportion to stockholdings.*

Appellants emphasize the fact that the advances evidenced by the notes were made in proportion to stockholdings. As stated above, the advances to the Mexican Corporation were not made by all the stockholders in proportion to stock ownership because Kroder and John-

son owned 20 per cent of the capital stock but made no advances whatsoever to the corporation. In any event, the District Court has closely scrutinized the transactions as required by the *Wilshire* case, and has determined that upon a consideration of all the circumstances, including the intent of the parties at the time the transactions were entered into, the notes were debt obligations within the meaning of I.R.C. Section 23 (k).

(2) *Ratio of debt to capital.*

Appellants contend that the ratio of debt to capital constitutes a feature militating against recognition of the notes as debt obligations. The amount of the debt was slightly in excess of $308,000. What were the total contributions to capital? The $1,000 paid to the corporation for the capital stock was for the purpose of complying with the Mexican law requiring that the capital stock be paid up. The real contribution to capital was the transfer of the mining rights to the corporation. Exhibit 53 (R. 258) indicates that Jones, Higgins and Harris acquired the option to the mining rights from Kroder in the form of an option of purchase. Jones, Higgins and Harris transferred the option to the Mexican Corporation (R. 88) and the corporation acquired the mining rights represented by Exhibit 56 (R. 269). As found by the District Court (Finding XXVIII, R. 61) such mining rights at the time of transfer by the Mexican Corporation to Jones, Higgins and Harris had a very substantial value in excess of the amount payable under the option and lease agreement, and such transfer of the mining rights constituted contributions to the capital of the Mexican Corporation by Jones, Higgins and Harris.

The transfer of such mining rights to the Mexican Corporation was not formally capitalized by the issuance of stock having a par value equal to the value of the mining rights. The failure to issue stock for the mining rights does not make such transfer any the less a contribution to capital. Mr. Jones testified as follows on cross examination (R. 105-106):

> "Q. So, the $1,000 paid in for the stock was the whole capital invested at the beginning, wasn't it?
> A. No, sir.
> Q. What else was invested?
> A. There was a mining value in the prospects of that mine that in my opinion had a minimum value of $50,000 and could run up into hundreds of thousands, due to the fact that those veins showed such excellent progress at that time . . . "

In the cases of *Maloney v. Spencer* and *Washington Institute of Technology,* supra, contracts were transferred by the respective taxpayers to the debtor corporations in return for all the capital stock of the respective corporations. Such stock had a substantial par value, but the transfers would have been none the less contributions to capital if the taxpayers had received in exchange therefor no-par stock or stock having an aggregate par value of $1,000. To hold that the validity for tax purposes of contributions to capital depends upon the issuance of stock having substantial par value would be a sacrifice of substance for form which is so abhorred by appellants.

If any significance is to be attached to the Mexican law which cast doubt on the validity of issuing newly created stock to aliens, such law affords a reason why

the Mexican Corporation did not formally capitalize the mining rights by issuing additional stock to Jones, Higgins and Harris.

The District Court not only found that the transfer of the mining rights to the Mexican Corporation by Jones, Higgins and Harris constituted contributions to capital, but also found that the mining rights at the time of such contributions to capital had a very substantial value in excess of the amount payable under the option and lease agreement. Very positive proof of such value is afforded by the fact that within six months after such contribution a third person paid $5,000 for a 10 per cent stock interest in the Mexican Corporation (Finding XXIX, R. 61). This would indicate that a 100 per cent stock interest in the Mexican Corporation was worth at least $50,000. The only asset accounting for such value of the stock was the excess in the value of the mining rights over the amounts payable under the option and lease agreement. As a general rule a purchaser will pay less than one-tenth as much for a 10 per cent stock interest as he would for a 100 per cent stock interest.

Consequently, $50,000 is a low estimate of the value of the mining rights contributed to the Mexican Corporation by Jones, Higgins and Harris. Mr. Jones testified that such value could have run up into hundreds of thousands (R. 105-106). It seems more reasonable to attribute a value of $100,000 to the mining rights. In short, Jones, Higgins and Harris contributed a minimum of $51,000 and probably $101,000 or more to the capital of the Mexican Corporation. On the basis

of the foregoing the ratio of debt to capital was no higher than six to one, and probably three to one or less.

In the case of *John Kelley Co. v. Commissioner,* 326 U.S. 521 (1946) the Supreme Court stated that material amounts of capital had been invested so that it was not necessary to consider the effect of extreme situations such as nominal stock investments and obviously excessive debt structure. The ratio of debt to capital in the Kelley case was four to one. As stated above, the ratio of the Mexican Corporation was probably three to one or less and was no more than six to one. Even a ratio of six to one is not so much greater than four to one as to constitute an extreme situation, particularly in view of the fact that Jones, Higgins and Harris expected that the advances required by the Mexican Corporation would not exceed $50,000 and had no idea that the advances would exceed $300,000. They fully expected that the venture would stand on its own feet and commence repayment after advances of not to exceed $50,000.

The contributions to capital of the Mexican Corporation were more substantial than the contributions to the capital of the corporations involved in the *Maloney* case, supra. The decision in the *Maloney* case attributes no value to the contracts transferred in return for all the capital stock. The ratio of debt to capital is only one of a number of factors to be considered and is not pertinent where there are other strong indications of the requisite intent. For this reason it was unnecessary in the *Maloney* case for either the District Court or this Court to discuss the ratio of debt to capital. Likewise,

there are no grounds for reversal of the District Court here even if it should be determined that the ratio of debt to capital of the Mexican Corporation was 300 to one, but as stated above the ratio was probably three to one or less, and not more than six to one.

(3) *Miscellaneous contentions of appellants.*

Appellants suggest that some significance should be attached to the fact that the stock of the Mexican Corporation was actually issued after the advances were made. In the *Wilshire* case, supra, both the stock and the notes were issued after the advances were made.

That any adverse inference should be drawn from the fact that Jones, Higgins and Harris failed to demand payment of the notes immediately when due is conclusively answered by the following statement of this Court in the *Wilshire case* (175 F. 2d pp. 720-721):

> "Under the circumstances no adverse inference should be drawn from the failure of the stockholders to demand payment immediately when due. The same strict insistence on payment on due date as would be the case if a bank were the creditor, should not be expected."

Likewise, no adverse inference should be drawn from the fact that upon liquidation of the Mexican Corporation Jones and Higgins paid off the liabilities of the Mexican Corporation without asserting their full rights as creditors under the notes.

The provision in the agreements that the notes shall be paid before any dividends may be declared on the

stock is a very common provision contained in loan agreements and indentures under which debt obligations are issued. Such provision would seem to be evidence of a debt obligation, rather than evidence to the contrary as suggested by appellants (B. 46).

(4) *No tax motive for the loans.*

Appellants' brief is resplendent with statements which suggest that the actions of Jones and Higgins constituted a "wholly useless temporary compliance with statutory literalness" (Br. 53) for the purpose of "depriving the United States of taxes" and to "disguise the true nature of a deduction claim" (Br. 32). Appellants further suggest that in some way the Internal Revenue Code is being "misread to subject the amount of tax liability to the substantially untrammeled control" of taxpayer (Br. 35) in such manner that "the intent of Congress would most facilely and flagrantly be obviated and the statute nullified by the mere passing of papers" (Br. 54).

Taxpayer trusts that such statements are not indicative of the sincerity with which appellants present their other arguments, because such inferences are wholly and obviously unfounded. There could have been no federal tax motive whatsoever for making advances to the Mexican Corporation in the form of loans rather than contributions to capital. The Mexican Corporation was not subject to federal income tax, so it made no difference whether or not interest was deductible on the advances. Notes gave no more tax benefit than stock.

If Jones and Higgins thought the likelihood of taking a loss was sufficient to warrant the drafting of the agree-

ments (Exhibits 53, 57 and 59) and issuance of the notes, they certainly would not have advanced the money in the first place. Furthermore, the decision to advance the funds in the form of loans rather than contributions to capital was made by Higgins as much as by Jones, and Higgins claimed no bad debt deduction for the more than $150,000 he lost in the venture. It made no difference to Higgins whether the notes were debt obligations or not since he sold his notes after they became worthless (R. 145-150).

Taxpayer submits that one, and only one, of the following propositions is true:

> 1. While optimistically advancing funds for the exploitation of a mining venture which at the time promised to be a bonanza, Jones and Higgins meticulously prepared agreements and issued notes primarily for tax reasons, although no tax consequence could possibly materialize from such agreements and notes unless the advances became worthless.
>
> 2. There was more than the "mere passing of papers" suggested by appellants, and for reasons other than tax considerations the parties really intended that the advances to the Mexican Corporation should constitute loans rather than contributions to capital.

The District Court was not clearly erroneous in determining that the second proposition is correct.

CONCLUSION

Taxpayer respectfully submits that the 32 notes of the Mexican Corporation were what they purported to be, and the judgment of the District Court should be affirmed because: (i) taxpayer owned no stock or other equity interest in the Mexican Corporation, so it is impossible to consider the 32 notes as adjuncts of a stock or equity interest; and (ii) in any event, the District's Court's conclusion that the 32 notes constituted debt obligations is not clearly erroneous, the District Court having correctly subjected the transactions to the close scrutiny required by the *Wilshire* case.

Respectfully submitted,

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